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VIA MAIL and E-Mail

Ms. Kirsten Walli
Board Secretary
P.O. Box 2319
2300 Yonge St.
Toronto, ON
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Dear Ms. Walli

Re: 3rd Generation Incentive Regulation for Electricity Distributors
Board File No.: EB-2007-0673
Comments on Staff Scoping Paper

As Counsel to the Vulnerable Energy Consumer's Coalition (VECC), I am writing to provide comments on the Board Staff's August 2, 2007 Scoping Paper for the upcoming consultation process on the development of a 3rd Generation Incentive Regulation Mechanism (3GIRM) for Electricity Distributors.

VECC's comments are broken into two sections. The first section provides comments on the points/issues raised in the Scoping Paper itself. The second responds to the specific questions raised on page 2 of the Board's August 2nd letter.

1 General Comments on Scoping Paper

Principles Underlying Development of 3GIRM

- Consumer Interests

The paper suggests (page 3) that the "interests of consumers" are captured by considering the "impacts of rate adjustments". VECC does not agree. First, consumer interests extend beyond rates/bills. Reliability of electricity supply and quality of customer service are also important to consumers. Indeed, the Board's statutory objectives recognize this as they direct the OEB to "protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service" (emphasis added). This broader perspective requires that service quality implications and considerations must be captured within the scope of the 3GIRM.

Second, consumer interests with respect to price (i.e., rates and bills) extend beyond simply the impact of rate adjustments. Consumers are also interested in ensuring that their electricity rates are as low as reasonably possible consistent with the provision of acceptable service levels. This means that their rates should only reflect reasonable and prudently incurred costs required to provide their service. It is not sufficient that the 3GIRM limit rate impacts. The 3GIRM must also provide assurance to customers that the rates they are paying are no more than what is required to cover the costs (prudently incurred) to provide their service.

- Economic Efficiency

The Staff paper appears to interpret the "pursuit of economic efficiency" as meaning that the 3GIRM should provide incentives for the implementation of sustainable operational efficiency improvements. VECC notes that the Board's objectives, as outlined in the OEB Act, take a broader perspective that includes generation and demand management as well as distribution. This broader perspective is consistent with the Government's policy of encouraging CDM. In addition, this broader perspective is also consistent with the achievement of efficiencies through greater distributor consolidation.

Having said this, VECC is of the view that there needs to be a balance between who pays for and who benefits from "efficiency improvements". In the case of distribution efficiency improvements, the balance will likely be appropriate as the costs of efficiency improvements will be borne by the same group of customers as those who benefit (i.e., the distributor's customers). However, in the case of generation, demand management and transmission, this may not be the case. In VECC's view it is inappropriate for the customers of a local distribution utility to bear a disproportionate share of the costs of promoting economic demand management or generation if the benefits are going to be shared with virtually all consumers in the province. Such initiatives are best undertaken by and paid for through the OPA, which will produce a fair sharing of benefits and costs. In addition, there are customers within a distributor's service area who, by virtue of income, age or domicile, often pay the costs but are not able to participate in programs and therefore get little to no direct benefit.

- Sustainability

In VECC's view the question of sustainability is a key "scoping issue" with respect to the development of the 3GIRM. Indeed there are a series of related questions including:

- What is the Board's expectation as to term of the 3GIRM? Is there a minimum length of time the plan should run for? Is there a maximum? Or, is the plan period open to full consultation and debate, i.e, within scope. This issue is important as the longer the plan's term the more robust it must be. Also, if the plan is to have a long timeframe (e.g. 5 years) then its must be flexible enough to incorporate the results of some of the Board's other future initiatives, such as rate design changes which are targeted for fiscal 2011.

- Can the 3GIRM can be subject to refinement (likely requiring further consultation and Board proceedings) during the period it is to be in place? This question is important in that it will define the timeframe for any research/analysis that is needed to support the incentive mechanism.

- Will distributors be able to "opt out" and file on a cost of service basis during the term if they so desire? The response to this question will be important to distributors as they consider the ability of the 3GIRM to meet their needs. It is also important to consumers, as clearly distributors will "self-select" to opt-out and, if such is allowed, there should be some symmetry in the process that protects rate payers.

Issues Regarding the Development of 3GIRM

- Cost of Capital

VECC acknowledges that cost of capital is not to be reviewed as part of this consultation. However, since full implementation of the target debt/equity structure of 60/40 will not be achieved for all distributors until 2010, the 3GIRM will need to be able to incorporate the implementation of the Board's EB-2006-0088 Decision regarding Cost of Capital. This may be easier to achieve under some incentive models than others and, therefore, influence the form of the 3GIRM. The Board should clarify that, as a prerequisite, the 3GIRM must be able to reflect changes in capital structure as directed in its EB-2006-0088 Report.

- Service Quality

The Staff Paper indicates that work is to resume on Service Quality Regulation (SQR) and proceed in parallel with the 3GIRM work. As noted earlier, service quality is an important issue with customers and is it is generally accepted that protection of service quality is a key issue/concern when developing incentive mechanisms for setting rates. As a result, it is VECC's view that the expected products of this work (if not the actual results) must be known prior to making any final decision regarding the form of the 3GIRM. For example, will financial penalties form part of the SQR? If not, then scope of the 3GIRM work may have to address more comprehensively what happens if distributors fail to meet their service quality targets.

- Necessary Elements

VECC agrees that the various "necessary elements" identified in the Staff Scoping Paper should be included the consultation's considerations. However, the Paper also suggests that the form of the 3GIRM will be considered, including the issue of whether or not a "British" style approach is appropriate. It is important that the question of whether the scope of the consultation is open to seriously considering models other than the price/revenue cap approaches traditionally utilized in North America be clearly confirmed. VECC's (preliminary) view is that approaches such as the one used in Britain could hold promise as a means of addressing issues associated with capital investment. However, since they represent a significantly different paradigm it needs to be crystal clear whether they are in or out of scope.

- Capital Investment

VECC agrees that issue of capital investments needs to be addressed as part of the 3GIRM. However, within this context, the 3GIRM should also address such questions as:

- The treatment of distributors with minimal capital needs during the 3GIRM period, and

- Under spending of approved capital plans/adjustments allowed into rates during the 3GIRM period.

In VECC's view the capital investment issue highlights the fact that the issues faced by individual electricity distributors can vary significantly. This begs the question of whether is practical to develop a 3GIRM that will address the needs of all of the 70+ distributors in the province and their customers. As a result, cost of service applications may still be required in some circumstances. Furthermore, there may be merit in making provision for more than one IRM mechanism.

- Lost Revenue Due to Changes in Electricity Consumption

VECC agrees that the 3GIRM must be able to incorporate LRAM for lost revenue due to CDM (as required by the Board's EB-2006—0266 Report) so as to remove the disincentive for distributors to undertake CDM. VECC also agrees that certain forms of incentive regulation, for example price cap, do not allow for regular updates/corrections to sales levels (unlike a traditional cost of service approach). Both of these issues should be within the scope of the 3GIRM consultation. However, the later issue should address both volume/sales increases and decreases.

However, VECC also notes that the Board's decision on Cost of Capital (including both ROE and capital structure) was based on a assumption that the distributor was exposed to various business risks, including that due to variation in sales due to business cycles etc. If the Cost of Capital question is not going to be revisited then the 3GIRM should not absolve the distributors of this business risk.

- Distributor Diversity

VECC agrees that it would be useful (and fair) if the 3GIRM recognized distributor diversity with respect to opportunities for productivity improvement/cost reductions. VECC also agrees that the work currently underway with respect to benchmarking cost performance holds some promise in this area. To this end, it is critical that the schedule for the work on cost performance benchmarking "dovetail" with the schedule for the work on 3GIRM.

While the integrated schedule recently issued by the Board calls for a Board Staff report on the comparison of distributor costs to be issued for comment on October 5th, 2007, VECC is concerned that comments do not seem to be due until January 15th, 2008. In VECC's view this is far too late. Conclusions will have to be reached during the 3GIRM Work Group process as to the relevancy and the applicability of cost performance benchmarking results if, as the Scoping Paper suggests, "consideration is to be given to the question of whether and how the results of the cost comparison initiative can be used in IRM". Indeed, it may be useful to have the 3GIRM Work Group the review of the Staff Paper targeted for October 5th and make suggestions as to follow-up work that could be done (prior to the end of November 2007) that could support the IRM initiative.

2 Response to August 2nd, 2007 Questions

Other Key Issues to be Considered

The preceding comments have noted a couple of additional key issues:

- Is the term of the 3GIRM within scope or does the Board already have a "term" in mind?

- Are there limits on the extent to which the 3GIRM can allow utilities opt-out, and if so when and under what conditions, or does the Board expect/require most (all) distributors to operate under the mechanism?

- Does there need to be a single 3GIRM or is more than one "model" (including cost of service) possible?

Additional scoping issues that need to be clarified include:

- Whether the 3GIRM is to cover Service Charges. In VECC's view this issue should be "on the table" and part of the Work Group's deliberations (i.e., the question of whether Service Charges should be in/out and, if out, how they are to be addressed should all be within scope).

- Whether the 3GIRM should include incentives to reduce losses. In VECC's view, this issue needs to be addressed either as part of the service quality exercise or as part of the 3GIRM. The Board should provide its thoughts as to where/how this issue is to be addressed.

- Is the plan to be comprehensive, or can it be partially cost of service based? VECC believes that this issue should also be "on the table". Indeed, there may be certain circumstances or cost components where "cost of service" is the approach that best meets the objectives of consumers, the distributors and the Board.

- One of the issues flagged during the development of the 2GIRM was the fact that a simple price cap did not properly track changes in capital costs (either debt or ROE). In its EB-2006-0089 Report the Board indicated that it was satisfied with this result for purposes of the 2GIRM. However, in VECC's view, the issue should be considered "in scope" for purposes of the 3GIRM.

As final observation on scoping, VECC notes that, given the potential range of issues, the timeline for the Working Group is extremely tight. As a result, if the Board has any predetermined views on the scoping issues, as it did with respect to incentive regulation for the gas utilities, it would be useful if the Stakeholder Working Group knew what they were at the start of the process. The tight timeline also suggests that the Work Group could benefit from the assistance of expert resources in the areas of incentive regulation and facilitation.

Use of Comparative Utility Cost Analysis in 3GIRM

As VECC noted in its June 2007 comments regarding the Consultant's Report on Benchmarking of Costs of Ontario Power Distributors (EB-2006-0268), the cost models and benchmarking results produced to date are not adequate for use in the 3GIRM. However, with improvements to the areas identified during the recent Technical Conference (e.g., inclusion of capital usage/cost and asset vintage measures) the results will hopefully be sufficiently robust to inform the 3GIRM.

This could be done in a number of ways. For example, the analysis could be used to define the “efficiency frontier” for distributors and then a unique productivity factor could be established for each distributor – assuming movement to this “frontier level” over an extended period of time. Alternatively, the Board could sponsor a TFP analysis for the industry overall to establish an average TFP factor and then use the results of the Benchmarking analyses to set individual distributor TFP factors.

Thank you for the opportunity to comment. If you have any questions regarding the comments please contact either Bill Harper (416-348-0193) or myself (416-767-1666).

Yours truly,

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